14. International Financial Markets and Instruments

International Financial Market

- A financial market is the mechanism that facilitates the transfer of funds from lenders (surplus units) to borrowers (deficit units).
- The institutions & instruments are integral part of financial market.
- When funds flow across national boundaries and the transfer is between parties residing in different countries, there comes into existence the international financial markets

Meaning

The international financial market is the worldwide marketplace in which buyers and sellers trade financial assets, such as stocks, bonds, currencies, commodities and derivatives, across national borders.

Sources of international funds

- The flow of funds from providers to seekers of international funds takes place through different institutions or agencies and through different financial instruments.
- The institutions or agencies that serve as the sources of international funds are;
  1. Multilateral development banks or agencies
  2. Government / governmental agencies
  3. International banks
  4. Securities market

Segments of international financial markets

International financial market facilitates the transfer of funds globally. The funds so transferred may be ownership funds or debt funds. The funds may be transferred for different maturity periods such as short term, medium term or long term. Segments of International Financial Markets;

1. Foreign Exchange Market
2. International Bond Market
3. International Equity Market
4. International Money Market
5. International Credit Market

Types

Short & medium term instruments

- Euro notes
- Euro commercial paper
- Medium term euro notes
- OTHERS
- ADR
- GDR

Eurocurrency is **currency** held on deposit outside its home market, i.e., held in banks located outside of the country which issues the **currency**. For example, a US dollar denominated deposit in a Singapore bank is **Eurocurrency**, or more specifically Eurodollar deposit.

Euro notes

- Like PNs for obtaining short term funds.
- Denominated in any currency other than the currency of the country where they are issued.
- Documentation facilities are minimum.
- Represent Low cost funding route.
- Investor too prefer them in view of short maturity.

Euro commercial notes

- A short-term, debt instrument
- Corporations issue euro commercial papers in order to tap into the international money markets for their financing.
- An example of a euro commercial paper is a British firm issuing debt in U.S. dollars to encourage investment from dollar-investors in international money markets.

Medium term euro notes

- Longer maturity between 1 year to 5 years.
- Short term euro notes are allowed to roll over.
- Issued to get medium term funds in foreign currency without any need for redemption and fresh issue.
- It is not underwritten yet there is provision for underwriting.
- It carry fixed interest rate

American depositary receipt (ADR)

What is an American Depositary Receipt – ADR

> “ *An American depositary receipt (ADR) is a negotiable certificate issued by a U.S. bank representing a specified number of shares (or one share) in a foreign stock traded on a U.S. exchange.*

BREAKING DOWN American Depositary Receipt – ADR

ADRs are denominated in U.S. dollars, with the underlying security held by a U.S. financial institution overseas. Holders of ADRs realize any dividends and capital gains in U.S. dollars, but dividend payments in euros are converted to U.S. dollars, net of conversion expenses and foreign taxes. *ADRs are listed on either the NYSE, AMEX or Nasdaq, but they are also sold over-the-counter (OTC).*

American depositary receipts were introduced in 1927 as an easier way for U.S. investors to purchase stock in foreign companies. Non-U.S. companies also benefit from ADRs, as they make it easier to attract American investors. Before ADRs existed, if American investors wanted to purchase shares of a non-U.S. listed company, they had to buy the shares on international exchanges. Purchasing shares on international exchanges has potential drawbacks, particularly currency-exchange issues and regulatory differences. Publicly traded companies have to answer to regulatory bodies with jurisdiction over their country. In the United States, the regulatory

body is the Securities Exchange Commission (SEC), which works to protect investors. The regulatory bodies implement and enforce rules on companies, including how companies should present pertinent financial information. Before investing in an internationally traded company, U.S. investors had to familiarize themselves with the different rules, or they could risk misunderstanding important information, such as the company's financials.

Benefits

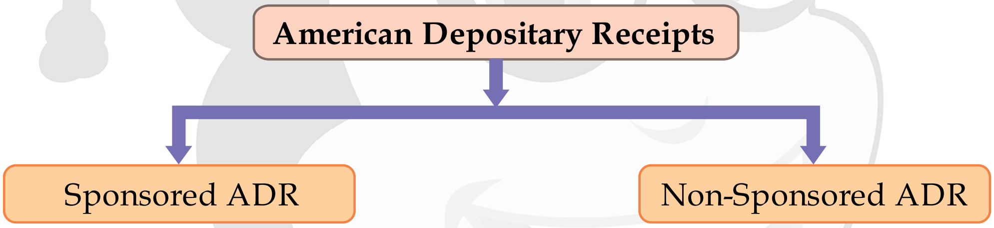
ADR holders do not have to transact in foreign currencies, because ADRs trade in U.S. dollars and clear through U.S. settlement systems. The U.S. banks require that the foreign companies provide them with detailed financial information, making it easier for investors to assess the company's financial health compared to a foreign company that only transacts on international exchanges.

Trading ADRs

To offer ADRs, U.S. banks simply purchase shares from the international company and reissue them, typically on U.S. exchanges. An ADR may represent the underlying shares on a one-for-one basis, or it may represent a fraction of a share or multiple shares. The depositary bank sets the ratio of U.S. ADRs per home-country share at a value that appeals to investors. If an ADR's value is too high, it could deter some investors, but if it is too low, investors may think the underlying securities resemble riskier penny stocks.

Types of American Depositary Receipts

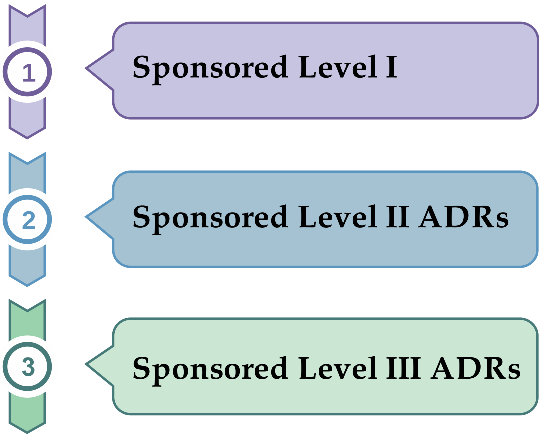
The ADRs that are sold in US financial markets can be categorized into sponsored and unsponsored.



1. Sponsored ADR : *For a sponsored ADR, the foreign company issuing shares to the public enters into an agreement with a US depositary bank to sell its shares in US markets.* The US bank is responsible for record keeping, sale, and distribution of shares to the public, distribution of dividends, etc. Sponsored ADRs can be listed on the US stock exchanges.
2. **Non-Sponsored ADR :** *A non-sponsored ADR is created by brokers/dealers without the cooperation of the foreign company issuing the shares.* Non-sponsored ADRs are traded in US over-the-counter markets without requiring registration by the Securities and Exchange Commission (SEC). Before 2008, any brokers and dealers trading in ADRs required written application and paper submissions before being allowed to trade in the US. The 2008 SEC amendment provided an exemption to foreign issuers that met certain regulatory conditions. Non-sponsored ADRs are only traded on over-the-counter markets.

Levels of American Depositary Receipts

ADRs are grouped into three levels depending on the extent of the foreign company's access to the US trading market.



1. Sponsored Level I

Level I is the lowest level that sponsored ADRs can be issued. It is the most common level for foreign companies that do not qualify for other levels or those do not want their securities listed in US exchange markets. *Level I ADRs are subject to the least reporting requirements with the Securities and Exchange Commission, and they are only traded over the counter.* Such companies are not required to issue the quarterly or annual reports like other publicly-traded companies. However, Level I issuers must get their stocks listed in one or more exchange markets in the country of origination. Level I can be upgraded to Level II when the company is ready to sell through the US exchange markets.

2. Sponsored Level II ADRs

Level II ADRs have more requirements from the SEC than Level I, and the company gets an opportunity to establish a trading presence on the US stock markets. The company must file a registration statement with the SEC. Also, the company must file Form-20-F in accordance with the GAAP or IFRS standards. Form 20-F is the equivalent of Form-10-K submitted by US publicly traded companies. If the issuer fails to comply with these requirements, it may be delisted or downgraded to Level I.

3. Sponsored Level III ADRs

Level III is the highest and most prestigious level that a foreign company can sponsor. A foreign company at this level can float a public offering of ADRs to raise capital from American investors through US exchanges. Level III ADRs also attract stricter regulations from the SEC than the other categories. The company must file Form F-1 (prospectus) and Form 20-F (annual reports) in accordance with GAAP or IFRS standards. Any materials distributed to shareholders in the issuer's home country must be submitted to the SEC as Form 6-K. Examples of foreign companies that managed to enter this ADR level include Vodafone, Petrobras and China Information Technology.

Termination of American Depositary Receipts

ADRs are subject to cancellation at the discretion of either the foreign issuer or depositary bank that created them. The termination results in the cancellation of all ADRs issued, and the delisting from the US exchange markets where the foreign company was trading. Before the termination, the company must write to the owners of ADRs to surrender their certificates or do nothing. The owners can swap their certificates for foreign securities represented by the receipts. If the owners take possession of the foreign securities, they can find brokers who trade in that specific foreign market. If the owner decides to hold onto their ADR certificates after the termination, the depositary bank will continue holding onto the foreign securities and collect dividends but will not sell more ADR securities.

Global depositary receipt (GDR)

What is a Global Depositary Receipt – GDR

A global depositary receipt or GDR is a bank certificate issued in more than one country for shares in a foreign company.

BREAKING DOWN Global Depositary Receipt – GDR

A GDR is very similar to an American depositary receipt or an ADR. It is a type of bank certificate that represents shares in a foreign company, such that a foreign branch of an international bank then holds the shares. The shares themselves trade as domestic shares, but globally, various bank branches offer the shares for sale. Private markets use GDRs to raise capital denominated in either U.S. dollars or euros. When private markets attempt to obtain euros instead of U.S. dollars we call GDRs EDRs.

Investors trade GDRs in multiple markets, which they generally refer to as capital markets as they are considered to be negotiable certificates. Investors use capital markets to facilitate the trade of long-term debt instruments, and for the purpose of generating capital. GDR transactions in the international market tend to have lower associated costs than some other mechanisms that investors use to trade in foreign securities.

Shares Per Global Depositary Receipt

Each GDR represents a particular number of shares in a specific company. A single GDR can represent anywhere from a fraction of a share to multiple shares, depending on its design. In a situation that involves multiple shares, the receipt value shows an amount higher than the price for a single share. Depository banks manage and distribute various GDRs and function in an international context.

Trading of Global Depositary Receipt Shares

Companies issue GDRs to attract interest by foreign investors. GDRs provide a lower-cost mechanism in which these investors can participate. These shares trade as though they are domestic shares, but investors can purchase the shares in an international marketplace. A custodian bank often takes possession of the shares while the transaction processes, ensuring both parties a level of protection while facilitating participation.

Brokers who represent the buyer, manage the purchase and sale of GDRs. Generally the brokers are from the home country and are sellers within the foreign market. The actual purchase of the assets is multi-staged, involving a broker in the investor's homeland, a broker located within the market associated with the company that has issued the shares, a bank representing the buyer and the custodian bank.

If an investor desires, brokers can also sell GDRs on their behalf. An investor can sell them as-is on the proper exchanges, or the investor can convert them into regular stock for the company. Additionally, they can be canceled and returned to the issuing company.

GDR'S

- ***Global Depository Receipt (GDR)*** *certificate issued by international bank, which can be subject of worldwide circulation on capital markets.*
- *GDR's are emitted by banks, which purchase shares of foreign companies and deposit it on the accounts.*
- *Global Depository Receipt facilitates trade of shares, especially those from emerging markets.*
- *Prices of GDR's are often close to values of related shares.*